RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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November 9, 1979 LETTER 769

Oct. 26, DJIA 809.30; PTI 1093; A-D Ratio –20.70
Nov. 2, DJIA 818.94; PTI 1093; A-D Ratio –19.99

THE PICTURE: I believe the big picture, as far as serious investors are concerned, is this: the Dow Industrial Average has to get above its 1978 peak of 907.74. Or the general market has to sink to a major oversold bottom. Nothing of major importance is going to happen until *one or the other of these two occur.*

The last push towards 907.74 was a failure. I take a dim view of this failure, and I do not think we are going to see another bona-fide attack on 900 this year. What this market needs (and it has been avoiding it for three years) is a **major oversold bottom**, a final "wipe-out" that will turn the public stone bearish and provide the base for a solid rise in all segments of the market.

In the absence of a Dow penetration of 907.74 (which I doubt will happen any time soon) or a smash to an historic oversold low (which could happen between now and the end of the first quarter of 1980), I see a frustrating stalemate for stockholders. Luckily, the money instruments offer a juicy alternative. So the investor's best friends over the foreseeable future should be (1) patience and (2) money instruments.

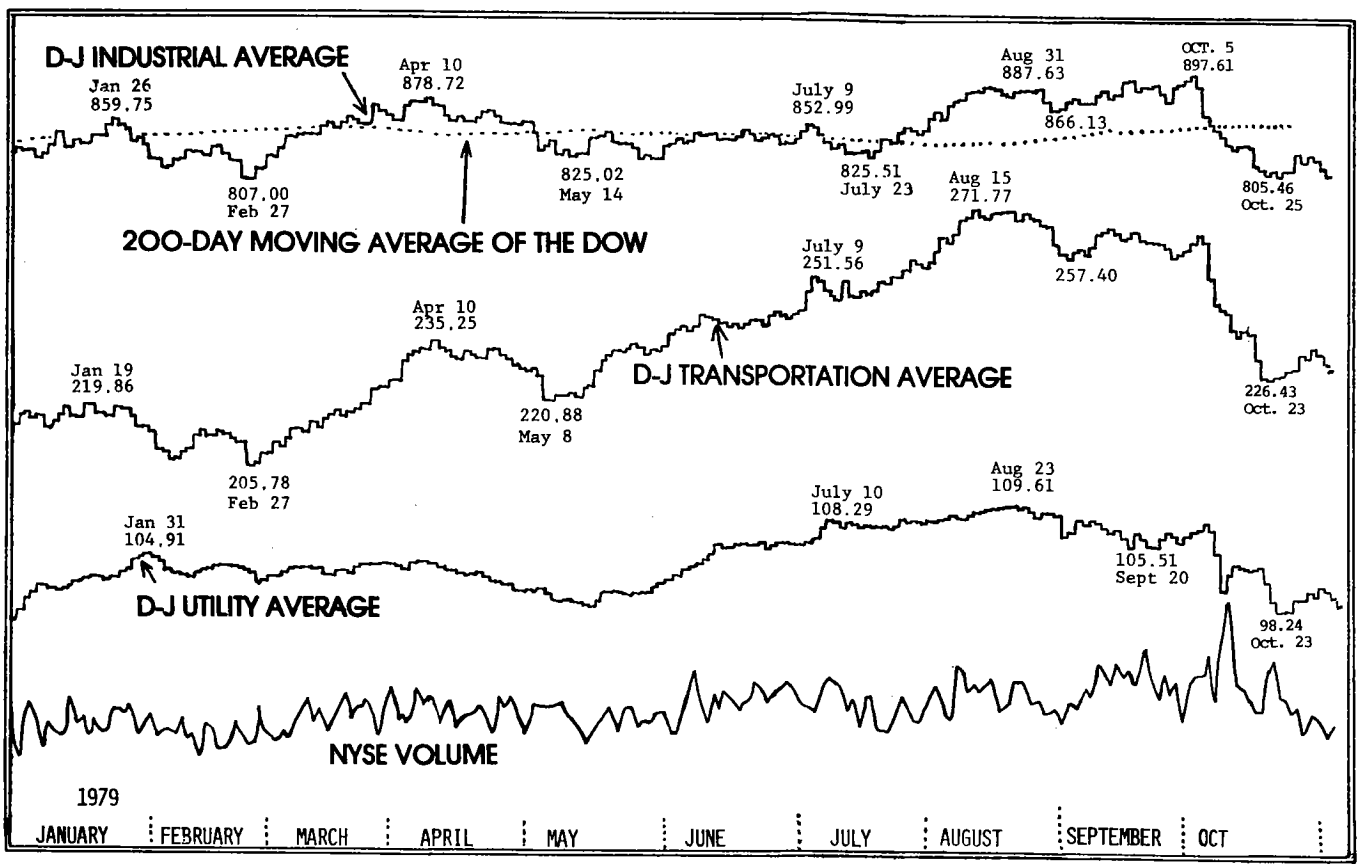
Now I want to write about something I've been thinking a lot about lately. You know the market (heartless monster that it is) has a way of making people look at the wrong place for the wrong reasons at the wrong time. Ol' man Wall Street is never happier than when he has thousands of investors searching through every nook and cranny of one room—and the real party is actually taking place in a room down the hall!

FRONT PAGE COMMENT: The one thing that never seems to change is human nature. Science changes, art changes, cities change, governments change—human nature remains relatively constant.

The market is made by the minds (and actions) of men. For that reason, history in the markets tends to repeat—although never in exactly the same way. If you study stock market psychology over a reasonably long period, say 20 years or more, you will note that there is one persistent phenomenon. That is the swing in market sentiment from abject gloom to great enthusiasm—and back to abject gloom again. Nothing in market history is surer or more constant than this never-ending swing in market psychology. The peaks in enthusiasm in the market are invariably marked by major tops. The depths of gloom are always delineated by major market bottoms. It's as simple as that.

As a rule, it is easier to identify the major market bottoms than the major tops. The reason for this is that major tops are generally formed during periods of extended and informed distribution. But major bottoms are a result of violent, often hysterical, dumping of shares. So while it may take many months to form a major top, a major bottom may form within a matter of a few weeks to a month.

The advance-decline ratio, probably the broadest measure of NYSE stock action, topped out last year in September. It topped



In all the years that I have been watching the markets, I've never seen as much professional advice being offered as today. The tools of the trade are now very much more *sophisticated*. Whereas 20 years ago (or even 10 years ago) we relied on such simple devices as the trend of the market, short interest, advance-decline ratio and volume, we now have service after service providing stock market studies of insider trading, public/specialist short ratio, advisory service sentiment, TRIN, short term momentum indicators, group momentum, you name it. And I wonder to myself, what is it all providing and where will it lead?

My fear is that it is all going to (1) lead to a stalemate, both in analytic technique and in the market, and (2) lead to most analysts and investors looking at the **wrong room** with a giant magnifying glass.

Today I read a report on a fund manager who boasted that he had performed marvelously over the past 10 years. His accounts had increased annually at a rate of 11% a year. Now that's nothing to sneeze at. It's a darn sight better than most other managers have done. BUT–here are all those amazing new stock market indicators and techniques coming up. Here are all these refined new methods being used. All in an effort to beat the market, or at least to increase batting performances in the market.

And all the while the money markets are offering astounding yields of from 10% (Government bonds) to 14% (bankers' acceptances) and even more for lower grade bonds. But of course, when you buy a bond you are stuck with a fixed yield, and inflation (if it continues rampant) can wipe you out just as sure as if you hold stocks during a bear market.

Nevertheless, there is the short-term money market. And with T-bills yielding around 12% (with no state taxes to be paid), I marvel that so much emphasis and energy is now being directed to beating the stock market. Why? Why?

The answer is real and logical. Analysts have to DO something. But more than that, stocks, by all historical standards but one, are cheap. I've gone over this a dozen times and so have many other analysts. Stocks are cheap on a book value basis, on a price&earnings basis, and on a dividend basis. Stocks are expensive in only one area–when they are compared on a yield basis with money market instruments.

Today, if I buy every stock in the Dow I get an average return of 6.16%. If I buy a long-term Government bond I get 10%. If I buy a closed-end bond fund I can get 12% yield. If I have a pension fund and I can get 12% on my money, then in a bit over 12 years I have *quadrupled* my money! Go beat that with stocks, a house, gold or anything else. Oh, you may beat it, I won't deny that, but I'm talking about a sure thing! I'm not talking about speculating or gambling, I'm talking about quadrupling my money safely on the basis of compound interest tables! And then I sit down and wonder, "Are too many smart analysts and too many inflation-battered investors looking through the wrong room with that big magnifying glass?

All of which brings me to one major conclusion at this time. I don't think that we are warranted (from here on) in buying stocks UNLESS they can be bought at a major (safe) market bottom, a bottom that offers a chance for a doubling or more of our money during the ensuing upward swing. In the absence of a major (and I mean MAJOR) stock market bottom, it seems to me (and I personally am acting on this) that the greater value is definitely in the money markets. In other words, with an option of a safe 10% to 12% yield, I don't have to sweat over a stock market that is not at an historic, safe bargain level.

out about 4 years after its 1974 low. But where is the next major bottom? Has it already occurred? Is it coming up? That's one of the most crucial questions on Wall Street today. I address that question in this Letter under the section entitled, "Where Is It?"

Ah, you reply, "What is a safe bargain level?" The answer to this is taken up in another part of this Letter.

* *

With the triggering of the three "danger levels" that I outlined in all the recent Letters, I take it that my subscribers are out of (or at least very light in) common stocks. I had thought that the 821 level was the platform from which a major stock market advance could be launched. If so, I wanted to get positioned. Alas, it was not fated to be. So I took minor profits and minor losses and got on the sidelines. "He who fights and runs away, lives to fight another day."

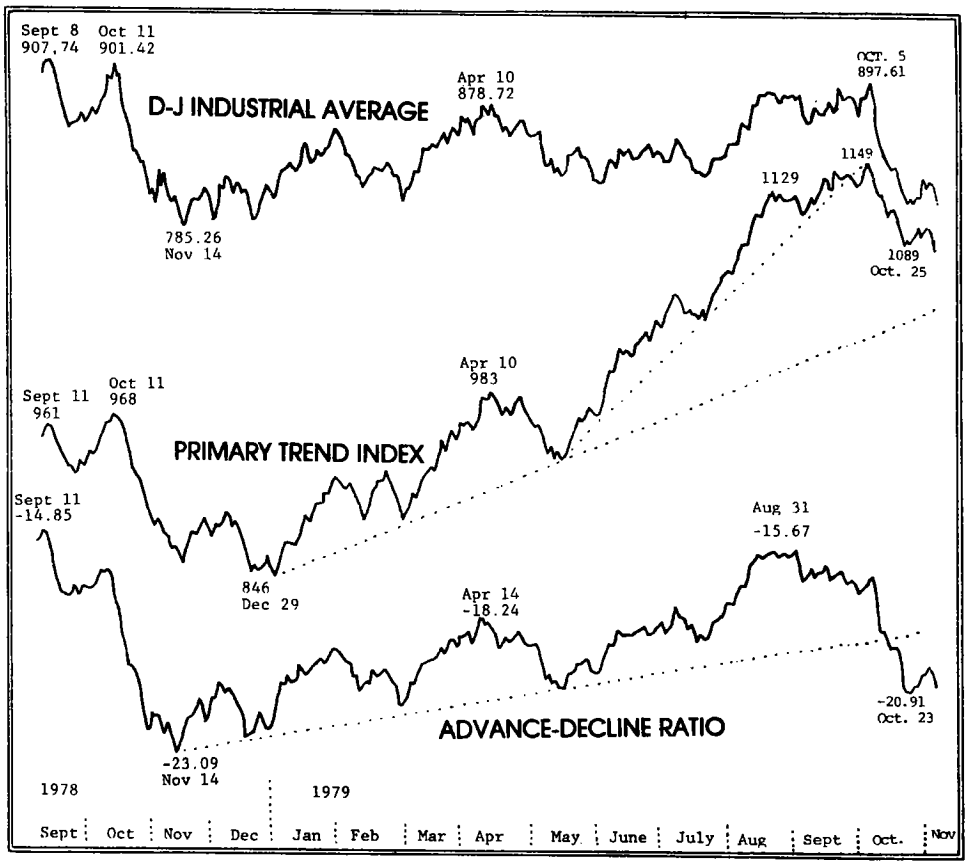
The decline from the October 5 highs erased 92 points in the Industrial Average, 39 points in the Transports. The decline (although hardly disastrous) had all the characteristics of a panic. One of the surer things in market action is the AUTOMATIC recovery of about 50% of losses following a panic low. The panic lows of late-October (see chart on page 1) were 805.46 for Industrials, 226.43 for Transports. If the panic recovery runs true to form, we can expect (in due time) Industrials to recover to around the 850 level, Transports to about 246.

The question, of course, is "Where does the post-panic rally start from?" It may take some further weakness and a testing of the 805.46 and 226.43 lows before a recovery can start. It is even possible that both Averages will break those lows. If so, the panic decline will extend downward before the ultimate 50% recovery sets in. I must say that if both 805.46 and 226.43 are violated, this market will appear weaker than I thought it was. But then, I have never before studied the Averages with a background of a 15.25% prime rate and an energy situation that is totally out of the control of the United States.

The action of the Primary Trend Index (see page 3 chart) has been somewhat surprising. The PTI lost 60 points on the entire panic decline of October 5 to October 25. This is not an excessive amount, but it is the recovery in the PTI that I am watching carefully. So far, the recovery has not been much, but we now have the 1089 (October 25) low as a reference point. I want to see whether this 1089 low holds over the remainder of the year–or whether it is taken out in the next decline.

On the same chart note that the A-D ratio has now broken decisively below its one-year rising trend. However, it has not yet broken below last November's low. The decline in the A-D this October was 5.24 points. From past history and my own familiarity with the A-D ratio's action, I would say that we will not soon see an A-D rally above its August high. The odds are more in favor of a trading range for the A-D–or a renewed major decline.

DOW THEORY: "Everybody talks about the Dow but nobody really studies the situation." Well, this writer does, but like so many things, it's easy to get lost in the daily action and hard to see the situation in terms of the larger (and much more important) picture.

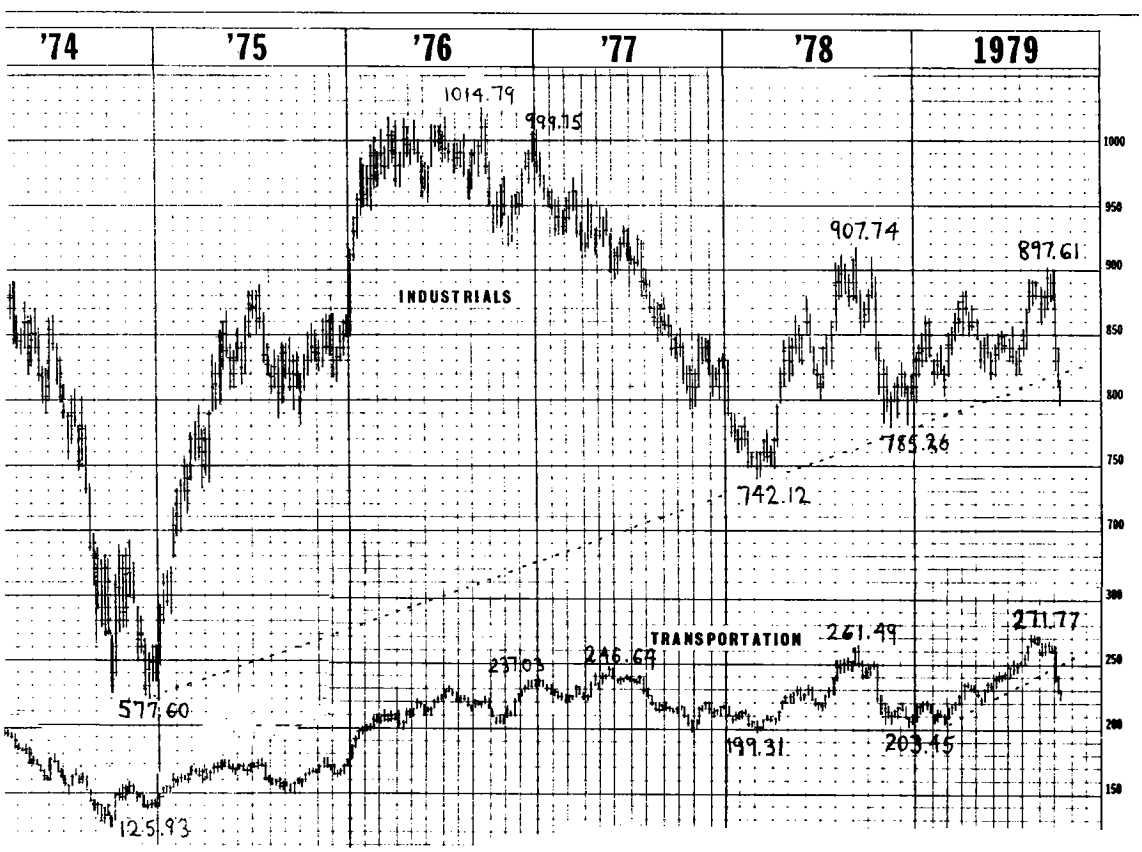


This chart (which I pieced together from Security Research) shows the weekly action of the Dow Industrials and Transports going back to the 1974 lows. As you can see, everything was fine up to September, 1976. On September 21, 1976 the Industrials recorded a peak of 1014.79. Following that high, the two Averages diverged. They diverged in one of the most dramatic parting of the ways in the history of the Dow Jones Averages. In fact, nowhere in stock market annals can I find a period where the Industrials and Transports diverged for three years running—as they have been doing since 1976!

Note the series of lower peaks on the Dow—1014.79 in 1976, 999.75 in 1977, 907.74 in 1978 and 897.61 this year in 1979. Against that series we have the following progression of new highs in Transports: 237.03 in 1976, 246.64 in 1977, 261.49 in 1978 and 271.77 in 1979. That's it, and the chart shows the whole picture in dramatic fashion.

What is the meaning of this historic divergence? Robert Rhea, the Dow Theory genius who studied the Averages for the better part of his adult life, concluded that extended divergence in the Averages generally implies distribution, and I basically agree with this thesis. At any rate, it seems to me that the divergence has reached the point where "something has to give."

One month ago the Industrial Average, having failed to better its preceding 1978 high at 907.74, turned down. Two weeks ago Industrials broke below the rising trendline which has been in force since the 1974 low. Transports then violated a secondary rising trendline which has held in force for the better part of 1979.



Where does that leave us? The next important set of downside low points are the 785.26 low of 1978 and the 203.85 Transport low recorded in 1978. Below those points are the 742.12 low of early 1978 and the comparable 199.31 level for Transports. If the two Averages break below those two sets of lows, the situation will become ominously bearish. But it is well to remember that it requires a penetration by BOTH averages in order for valid conclusions to be drawn. Thus, if one Average were to break below its 1978 low and the other refused to confirm, it could be a

turning point rather than a victory for the bears. From here on it will pay to keep a cool head–as the Averages spell out their prophetic story.

WHERE IS IT? There's a study that has been bothering me ever since I first discussed it back in Letter 726. It has to do with the 4½ year stock market cycle and a certain indicator that I follow which has proved to be a great aid in identifying MAJOR bottoms (as differentiated from secondary bottoms).

Please study the accompanying chart. This chart shows the Dow on a monthly basis going back to 1948. I have identified the MAJOR cyclical bottoms by down-arrows. These cyclical bottoms have, since World War II, come about every 4½ years. You can identify them on the chart: 1949, 1953, 1957, 1962, 1966, 1970, 1974. How did we know they were major bottoms? Simple, the market plunged dramatically prior to each of these bottoms. As a result, they are very easy to identify on the chart. Second, each of these dramatic lows was followed by a major rise in the stock market, a rise of a few years or more (all except for the post 1974 rise, which saw the Dow top out in 1976).

However, I follow a second tool which makes identification of MAJOR over-sold areas (major bottoms) rather simple. It is therefore a confirmatory tool. This indicator (based on the collective strength or weakness of a large universe of NYSE stocks) oscillates between fixed ranges and it has swung between these ranges (as you can see on the chart) ever since World War II. The black solid areas on this indicator denote MAJOR oversold areas, or areas in which heavy buying of stocks was warranted.

In every case, the cyclical lows on the chart (the 4½ year cyclical lows) were confirmed by this indicator. But it is the 1978-79 area which represents the big mystery. On a simple examination of the price movement of the Dow, it seems extremely doubtful whether a cyclical low has appeared. Some analysts claim that the early-1978 low shows on the chart as enough of a downward sag to fit into the general picture of a major bottom. I am skeptical. What makes me even more skeptical is that the lower indicator has steadfastly, since 1974, **refused** to drop to the area of major oversold bottoms.

Last week this indicator dropped to its lowest level since its 1976 peak, but the indicator is still a good distance from the solid black major oversold area.

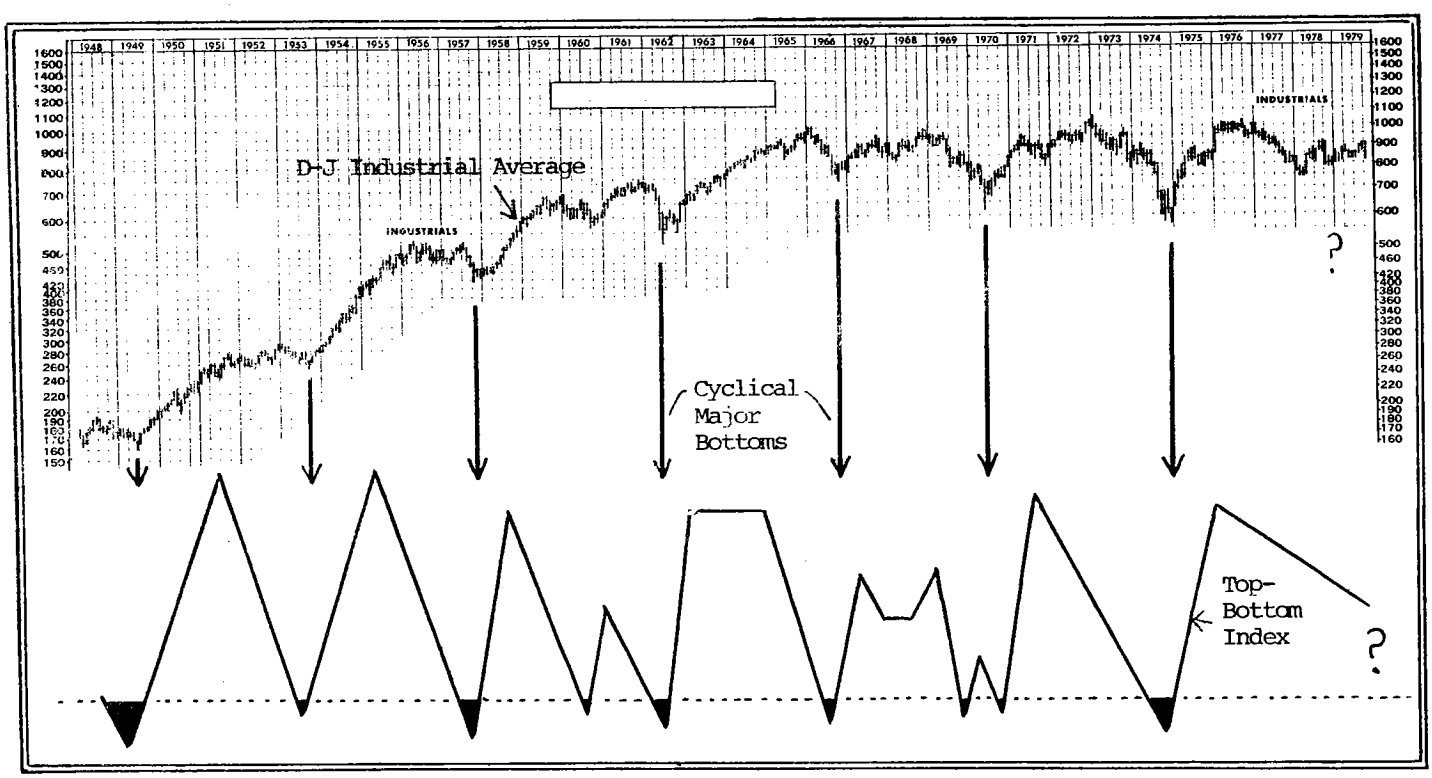
Five years have elapsed since the historic major bottom of late-1974. This is the longest time span without a major oversold market bottom in the entire period since World War II. As I see it, there are two possible view of the current situation.

(1) The whole technical structure of the market has changed, possibly due to inflation or to persistent Fed manipulation.

(2) The market is now heading for the "long lost" major oversold area. If so, the final oversold bottom will be identified by a downward spike in the Averages and it will be confirmed by the special indicator dropping into the black for the first time since 1974.

NOTES & QUOTES: Now that Michael Blumenthal is out as US Treasurer, he's cleansing his soul and telling the truth, at least as he sees it. It's pathetic that a man has to leave Washington before he'll say what's on his mind. In my opinion, what separates men from boys is their insistance on telling the truth at all times (can you picture Jesus or Confucius or Mohammed lieing for political expediency!).

At any rate, here are a few of Blumenthal's real views, taken from an interview a few weeks ago. "More pressure" on the dollar, higher unemployment, high interest rates for "many months to come" and a 1980 Federal budget deficit "closer to $50 billion than $40 billion." He also noted, "In Plains, all the talk was about the necessity to stimulate the American economy. All of the concern had to do with making sure that unemployment would not rise again . . . . The real problem was not a major slowdown, but really an endemic, inbuilt, growing inflationary



pressure; we occupied ourselves with developing stimulus packages." Politics is delightful, isn't it!

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Irony: For the past few years Europeans have been insisting that the US "defend the dollar" at all costs, one of those costs being high interest rates. A few weeks ago Mr. Volcker made the move. What happened next? Europeans rushed to defend their own currencies. How? With higher interest rates of their own, of course (which somewhat nullifies the international benefits to the high-yielding dollar). In the last two weeks, Germany boosted her bank rate from 5% to 6%, Netherlands upped her rate from 8% to 8½%, Japan raised its rate from 5¼ to 6¼%. Last week Switzerland raised her rate. Could we be seeing the early part of an international interest rate war?

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Add to your list of "books that will never be written" this– "The New Orleans Diet Book." We just returned from the great National Committee For Monetary Reform seminar in New Orleans (thanks, James Blanchard). The Conference was a lot of fun and very enjoyable (Paula was too busy chasing Ryan around to enjoy herself too much). Our diets were blown sky-high in this city of very serious eaters. After one particularly monstrous and late dinner, I got about 4 hours sleep. Why, because Morgan Maxfield got me up at 5:30 a.m. and we jogged (rather he dragged me) around the Superdome. If you don't think the Superdome is huge, try jogging around it at 5:30 a.m.!

I'm back in California eating pita bread, tomatoes and cucumbers again. Nobody jogs (that I could see) in New Orleans. You can't eat that irresistible creole food and do any running. But then, you don't find any gourmet food in San Diego. San Diego is an exercise town, New Orleans is an eating and drinking (and I mean 24 hours a day) town. I've never seen so many people in so many restaurants anywhere else.

The New Orleans Conference broke all records with 3,000 in attendance. I liked most of the speeches, but nothing I heard changed my mind. I really enjoyed seeing alot of my old friends and buddies such as Harry Browne, Mike Kaller (the stamp expert), R. E. McMasters and Walt Bressert (both commodity stars), the inimitable James Dines, Irving and Martin Weiss, the Blanchards, C. V. Myers, and the list goes on and on.

A day before his surprise appearance, I spoke by phone to Governor Jerry Brown, and spent half an hour trying to explain to him "what kind of a crowd" this conference would offer. "It's a hard money audience," I gold the Governor, "They're wealthy, worried, and they believe in gold, not Governmental promises." I couldn't stay for the Governor's speech, but it should have been interesting. Maybe somebody could tell me about it.

Most ominous words from New Orleans, James Dines predicting that "this bear market will give us an ultimate Dow low between 400 and 150!" "James, have mercy on us!" But James has been right enough so that people don't laugh at his predictions.

Biggest surprise for me; top money manager Monty Guild expecting short-term interest rates to top out in the 17% to 19% area (did I hear him correctly?) but saying that he's carefully accumulating selected stocks (brother, that's courage).

* *

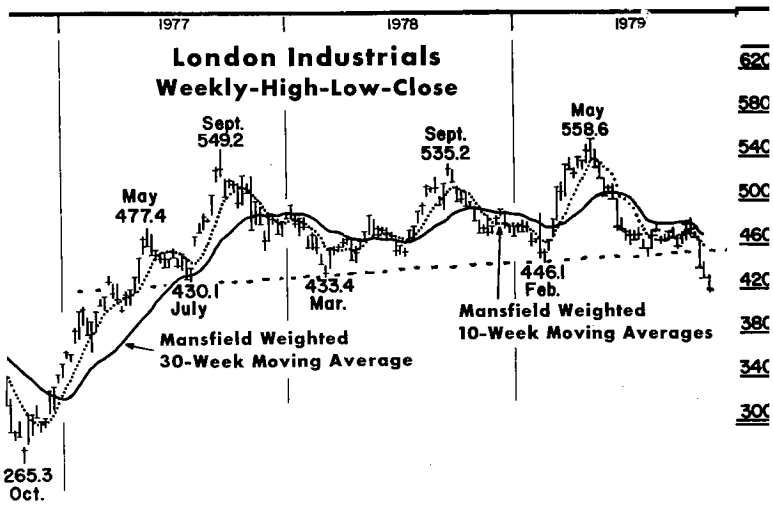
If you read the Wall Street Journal, you have probably noted that the corporate earning statements coming through are, in many cases, surprisingly poor. In the case of the autos, they're terrible. All this is occurring prior to the long-promised recession. It makes me wonder how things will look when a real recession actually hits. The fact is that there is no bigger squeeze than costs going up while volume of sales is declining (with a high cost of carrying inventory and debt as a further depressant).

* *

It may all be settled by the time you read this, but I find the US sitting on its hands while Iranian students take over the US Embassy in Iran–a picture hard to take. If Teddy Roosevelt was here, he'd have that Embassy swarming with Marines. But we've come a long way since Teddy, yes indeed!

* *

The old market adage states that the US stock market bottoms first while the London market tops first. If so, London is telling a story worth hearing. Few people are aware that the London Industrials have quietly sliced below four preceding bottoms, dropping to their lowest levels since early-1977. To put it gently, this is not a good omen for the US market (and London is not dependent on OPEC oil, either). The chart is courtesy of Mansfield Inc., 26 Journal Square, Jersey City, NJ 07306.

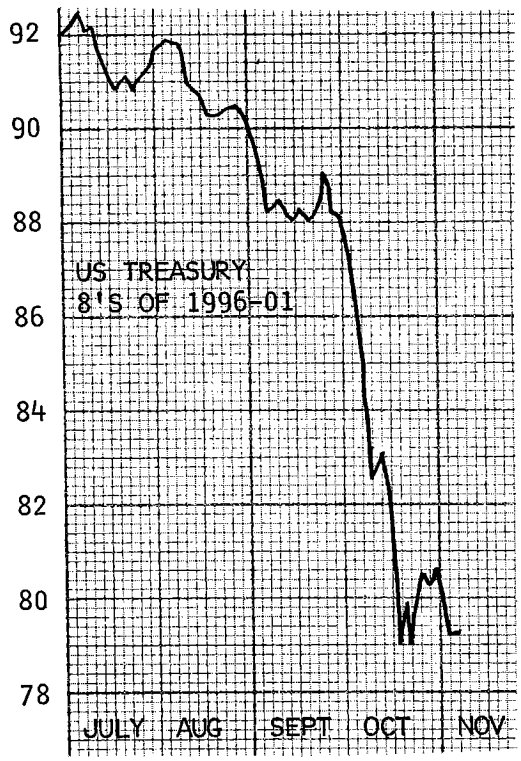


BONDS: The stock market never hits bottom in a major way until bonds make their lows. In other words, bonds record their lows first. My charts show an ebbing of the bond decline, a slowing of the downward momentum. But they don't show me a low for the long-term bonds–yet.

The losses in bonds have been astronomical. Nobody knows the exact size of the total bond market but it is between one and two trillion dollars. The losses across the board have been above 10%, probably the biggest bond smash in a compressed period of time in history. I estimate the total bond losses at around $200 billion. Those losses will be felt in the banks and in the economy, but it will probably take three or four months to get the whole effect.

To me, there is nothing more demoralizing than realizing that there just is no real safety in long-term bonds any more. The man who buys bonds maturing in say twenty years is taking his financial life in his hands. First, because he doesn't know where the dollar will be in twenty years, and second because the way things are going he doesn't know whether the corporation or city issuing the bonds is going to be solvent in twenty years. Maybe things aren't as bad as the bond market is suggesting, but if you watch the money markets it's hard to be an optimist these days.

To illustrate, I include this chart of the bellwether Treasury 8's of 1996-01. I've never seen a Treasury bond do this before, and I don't think it's ever happened before. Let's hope that little squiggle at the lows is the beginning of a major bottom. Let's hope . . . .



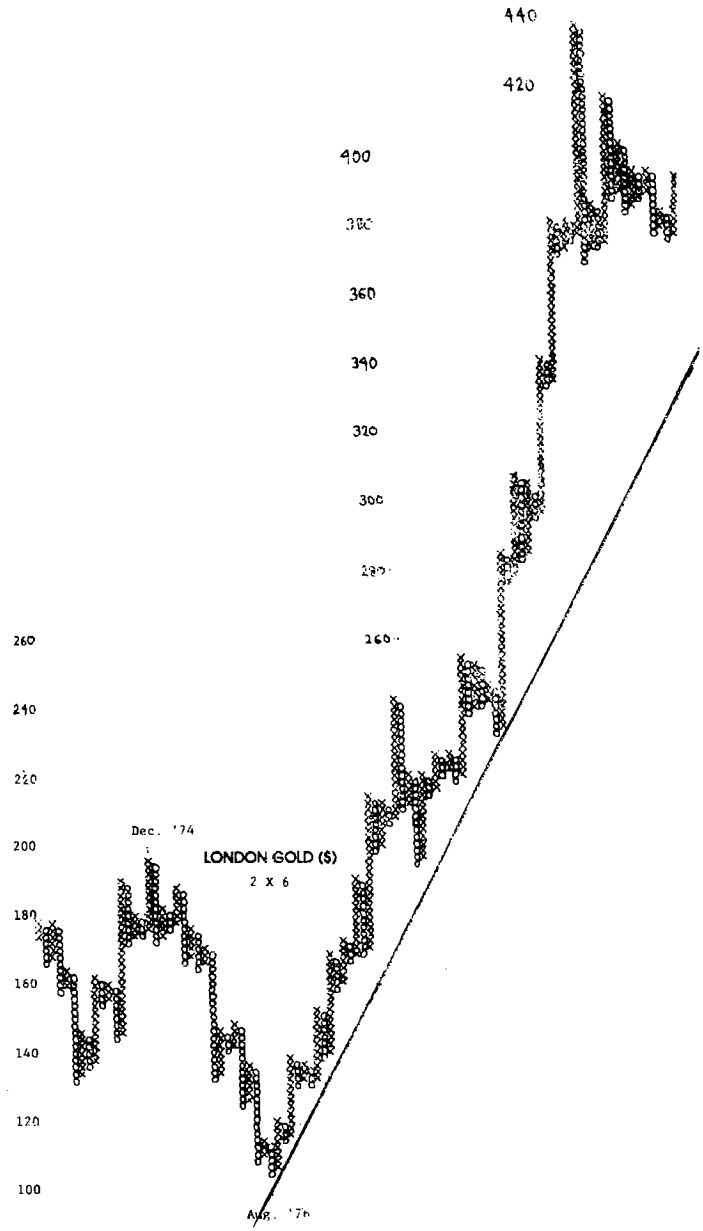
GOLD: If you've been trying to trade gold in 1979, you've undoubtedly had your problems. The November 6 WSJ (back page) documents the 1979 commodity story and quotes one prominent gold broker as saying, "In terms of sheer volatility and viciousness there has been nothing comparable with the silver and gold markets of today." An error by this broker (on a day when gold whipped over a $47 range) cost him $32,000!

This 2 X 6 point & figure chart of gold shows all the action since 1973. I've drawn a rising trendline up from the 1976 bottom. This trendline has never been violated on any correction of the past three years. As you can see on my chart, gold is now doing something a bit different from anything it has done since the 1976 low.

What it is doing is forming a structure with a peak in the 440's area and a base in the 364-368 area. Four years ago or even two years ago I would have (without hesitation) labeled this a "very toppy pattern." I would have said this because up to 1976 or so gold was a beautiful item to follow–it charted easily and seldom produced deceptive signals. With the arrival of the commodity speculators and the public, this changed. Gold is now tricky, whippy, hard to trade and deceptive to follow.

"Oh, just buy it and put it away," I'm told. That's fine for a limited quantity of gold coins (say 10% to 15% of assets) as long as you treat those coins as a "survival package" never to be sold. But when you're talking about a major position in gold or anything else, you don't just "put it away and forget it." If you do, you'll wake up in a sweat some fine morning and find that your best laid plans have turned to fluff and that sweat on your brow has turned to ice.

My own feeling is that gold at these prices has to be watched much like anything else. I don't think the big gold positions that we used to have are now warranted, at least I won't carry them. But as long as spot gold holds above 364-368 the chart is saying that this could be accumulation instead of distribution–and nobody can disprove that statement as yet.



I personally feel comfortable today with the bulk of my assets in 91-day Treasury bills. It may be boring collecting 12% on my money, but then I never asked my investments to provide my daily excitement. As far as I'm concerned investments give me purchasing power, and purchasing power gives me a certain amount of freedom. Anyway, that's the way I look at it, but if you have a better or more satisfying approach, I'll certainly respect it.

LATE NOTES: On November 6 the PTI broke to a new low for the move (the chart on page 3 shows it) and if the PTI continues to make new lows it will be telling us that the technical underpinnings of this market are eroding away. The low volume of the last few days is not bullish, and the negative volume indices are now breaking to new lows. Prognosis: caution.

THEY ALL COME TO SAN DIEGO:

—Several years ago, **Steven West** wrote a book entitled "How to Live Like a Millionaire." Recently, the former chairman of a defunct Detroit department store chain filed for bankruptcy in San Diego, listing $6,800 in assets and $8,337,161 in debts.

NEXT MAILING: November 21